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## PERSPECTIVE

## Challenges to female director law: not a deluge, a drizzle

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To paraphrase Mark Twain, reports of the wave of litigation that was expected to follow enactment of California's Senate Bill 826 (which requires a minimum number of women directors in publicly traded California-based companies), have been "greatly exaggerated."

In 2018, the passage of SB 826 was met with extreme skepticism, as industry participants, the media, and academics questioned the constitutionality of a sex-based requirement. Numerous publications predicted that a raft of litigation would tie up efforts to enforce the bill. These criticisms echoed comments in the bill analysis of the Assembly Judiciary Committee. Even Gov. Jerry Brown's signing statement acknowledged that the law was vulnerable to constitutional challenges.

But now, with the first compliance deadline looming on Dec. 31, and despite the fervor over predicted litigation, only two suits have challenged the legality of SB 826. And neither action is brought by any of the 537 corporations that California maintains are subject to the law.

The first suit, filed Aug. 6, in Los Angeles County Superior Court, is brought by three California taxpayers under Section 526a of the Califor-



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nia Code of Civil Procedure, a provision which permits taxpayers to sue for illegal expenditures of state funds. *Crest v. Padilla*, 19STCV27561. The complaint alleges that SB 826 violates the prohibition on gender-based discrimination in Article 1, Section 31 of the California Constitution and that the \$500,000 the state predicts that it will require to monitor and enforce compliance with the law therefore constitutes an illegal expenditure of state funds. The plaintiffs are represented by Judicial Watch, a conservative watchdog group. The suit seeks a declaratory judgment finding that SB 826 is unconstitutional and an injunction against enforcement of the law. On Oct. 23, the state filed a demurrer alleging that the plaintiffs lacked standing under Section 526a and that their alleged claims are not ripe because the secretary of state has yet to issue regulations to implement SB 826 or impose fines on

corporations for noncompliance. The demurrer asserts that SB 826 is constitutional but does not discuss the questions of constitutionality raised in the complaint and focuses instead on procedural weaknesses. A hearing on the state's demurrer is set for March 9, 2020. If the demurrer is denied the case will proceed to discovery and possibly progress to trial.

The second suit challenging SB 826 was filed on Nov. 13 by Creighton Meland Jr., a shareholder of OSI Systems, Inc., in federal court in Sacramento. *Meland v. Padilla*, 2:19-cv-02288-JAM-AC (E.D. Cal). OSI Systems is a publicly traded company headquartered in California with a seven member, all-male board of directors. Meland alleges that SB 826 violates the equal protection clause of the U.S. Constitution because it injures his right to vote for the board candidate of his choice "free from the threat that the corporation will be

financed if he votes without regard to sex." *Compl.* ¶ 28. Meland is represented pro bono by Pacific Legal Foundation, a libertarian public interest law firm in Sacramento. Like the plaintiffs in the *De Vries* action, Meland seeks both a declaration that SB 826 is unconstitutional and an injunction prohibiting the state from enforcing the law. The state's response is due on Jan. 6, 2020. Presumably, the state will move to dismiss the complaint, possibly raising procedural challenges on standing and ripeness grounds. If the motion to dismiss is denied, the case would move to the discovery phase early next year and potentially on to trial.

It is too early in the process to make predictions about the success of either of these lawsuits — much will depend on litigation strategy, the outcome of procedural challenges, and the amount of resources marshalled on either side. But the constitutional challenges raised by both cases, if successful, could enjoin implementation and enforcement of SB 826. Further, as Professor Joseph Grundfest at Stanford Law School warned, the ultimate decisions in these cases could shape and influence other pieces of affirmative action litigation. Joseph A. Grundfest, "Mandating Gender Diversity in the Corporate Boardroom: The Inevitable Failure of California's SB 826," Working Paper (Sept. 12, 2018). However,

while the risks posed by these suits are significant, the absence of key stakeholders from the litigation arena is more notable.

The paucity of litigation suggests that the corporations affected by the law are either willing to comply voluntarily or lack the appetite to challenge the legislation. In fact, a recent study by Clemson University researchers reviewed proxy statements by companies subject to SB 826 and found that, following the passage of the board gender diversity law, the percentage of female directors per firm rose by 3.4%, from 15.1% to 18.5%. Green et al., “Do board gender quotas affect firm value? “Evidence from California Senate Bill No. 826,” SSRN (Oct. 2, 2019). Even OSI Systems, the company in which Meland holds shares, is nominating a female director candidate in its proxy statement for the company’s upcoming annual meeting on Dec. 12. The proxy was issued Oct. 22, several weeks before Meland filed his complaint.

Nonetheless, critics of the law, including Professor Grundfest, argue that a quota system is not required to get more women on corporate boards. They point out that shareholder actions, including pressure by institutional investors, are already moving the needle on boardroom diversity. In the second quarter of 2019, women held over 20% of board seats at the Russell 3000 and women won over 40% of new board seats, according to an Equilar Diversity Network survey.

But the trend towards more female directors has been slower to catch on in California. A Columbia Law School analysis found that when mea-

suring board diversity by the percentage of large cap companies with two or more female directors, California ranks only 37th among states (controlling for size). Mikayla Kuhns et al. “California Dreamin’: The Impact of the New Board Gender Diversity Law,” The CLS Blue Sky Blog, (Jan. 4, 2019).

And why might that be the case? Studies show that adding women to boards doesn’t lead to higher stock prices — in fact, it’s the opposite (at least in the short term). The Clemson University study found that California companies experienced an average 1.2% loss in stock value following passage of SB 826. This result is consistent with a recent Harvard Business Review study which finds that corporations experience a decrease in stock value for two years following the appointment of a female director even though firm profitability remains largely unaffected. Sadly, the authors attribute the drop in stock value to a perception that adding a woman to a board (instead of a man) suggests to the market that the company is less focused on maximizing shareholder value. Isabelle Solal and Kaisa Snellman, “Why Investors React Negatively to Companies That Put Women on Their Boards,” Harvard Bus. Rev. (Nov. 25, 2019).

So it isn’t terribly surprising that when faced with mixed results of studies on the financial benefits of adding women to a board, shareholders and directors may hesitate to advocate for changes. The Harvard Business Review article noted that, while five of the largest U.S. activist funds had succeeded in getting over 100 board members appointed between 2011 and 2016, only seven of those

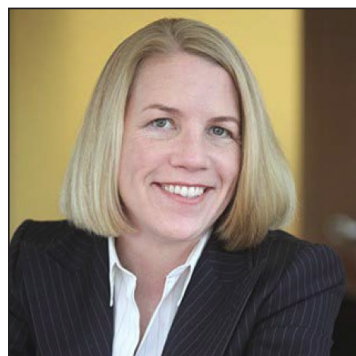
appointees were women. This trend may be shifting. More recently, State Street and BlackRock, two of the most recognized institutional investors, added diversity goals to their proxy guidelines. It remains to be seen how the positions of these companies may affect the actions of other institutional investors or affect the trends towards boardroom diversity on the whole.

If companies choose to expand their boards rather than replace current directors, the likely costs of director compensation, insurance, and training will likely increase. For smaller companies these costs may have a larger impact on their financial resources. Of the 114 companies subject to SB 826 with five or fewer board seats, the Columbia Law School analysis observed that 71% had zero female representation as of Jan. 4, 2019. Given the potential costs involved in adding board members, some smaller companies may have conducted a cost benefit analysis and could opt to pay the \$100,000 fine for non-compliance. But this strategy will be less sustainable in 2021 when

the legislation requires the appointment of at least two female directors for boards of five or more members and the fine for repeated non-compliance rises to \$300,000. *See* Cal. Corp. Code. Section 301.3(e). In the face of these costs, SB 826 may provide diversity advocates the weight needed to tip the scales in favor of voluntary compliance.

Given that board diversification does come at a cost (at least temporarily) for shareholders, the potential of California’s law to arm activist efforts and inspire voluntary compliance is especially important. Contrary to the dire predictions of litigious havoc, the lack of legal challenges and the data gathered to date suggest that companies and stakeholders would rather add women to their boards than expend the resources to challenge it. In reality, the benefits of SB 826 are being realized not through the threat of future enforcement and penalties but through voluntary compliance. As a result, in its first year, the legislation has already defied expectations and increased the gender diversity of boards in California. ■

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